

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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date: January 23, 2021

to: Luke D. Ortner  
Attorney (Denver, Group 3)  
(Small Business/Self-Employed)

from: John P. Moriarty  
Associate Chief Counsel  
(Income Tax & Accounting)

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subject: Costs Permissibly Capitalized to Inventories for Resellers under Section 471

You have asked for our advice concerning what costs may a reseller appropriately capitalize to goods acquired for resale if a taxpayer is taking inventories under section 471 of the Internal Revenue Code and the corresponding Income Tax Regulations. This Chief Counsel Advice memorandum responds to your request for advice. This advice may not be used or cited as precedent.

**FACTS**

For purposes of the analysis set forth below, assume the following facts:

Taxpayer is organized as a C corporation for purposes of Federal income taxation and is not classified as a tax shelter (as such term is defined in section 448(d)(3) of the Internal Revenue Code). Taxpayer's average annual gross receipts for the 3-taxable-year period ending with the taxable year prior to the current taxable year is \$4,000,000.

Taxpayer has a single trade or business, as defined in section 446(d) of the Code, in which it purchases and resells units of tangible personal property (hereinafter referred to as "goods") that constitute merchandise (as such term is used in section 471 of the Code and the applicable regulations) in the hands of Taxpayer. Taxpayer does not produce any of the goods itself nor does it engage in any production activities on behalf other entities.

In purchasing and reselling the goods, Taxpayer incurs various costs. These costs include costs of acquiring ownership and possession of the goods (the purchase price of the goods and the cost of shipping the goods from the producer of the goods to Taxpayer, plus certain other necessary charges incurred in acquiring possession of the goods) (hereinafter, the “acquisition costs”), as well as, certain purchasing costs, certain storage and handling costs, costs of preparing the goods for resale (including inspection costs, packaging costs, and the labor associated with these activities) and of reselling the goods (selling expenses, including associated labor costs).

Taxpayer takes inventories of its goods as required under section 471(a) of the Code and values its goods at cost. Although Taxpayer meets the gross receipts test in section 448(c), Taxpayer does not account for its inventories under any of the methods set forth in section 471(c) of the Code. Furthermore, Taxpayer meets the gross receipts test in section 448(c) and does not apply the rules in section 263A of the Code (or the associated Regulations) in determining the costs that it capitalizes to the goods in its inventory or the manner in which it allocates costs to the goods.

### ISSUE

What costs may Taxpayer capitalize to goods in its inventory if Taxpayer is taking inventories pursuant to section 471 and its regulations and if such inventory is solely comprised of goods that are purchased and resold by Taxpayer?

### CONCLUSION

Because Taxpayer is not applying section 263A or section 471(c) in determining the cost of its inventory, it may only include the invoice price of the resale goods (less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed) and the transportation or other necessary charges incurred in acquiring possession of the goods.

### LAW

Under section 471(a) of the Internal Revenue Code, “[w]hen in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.”

Under section 1.471-1(a) of the Income Tax Regulations, “. . . in order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.”

Section 1.471-2 of the Regulations sets forth that a taxpayer's inventories are generally valued at cost, with certain exceptions for taxpayers permitted to value inventories at the lower of cost or market and for "subnormal" goods (that is, goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange). See section 1.471-2(c). In order to value inventories at cost, a taxpayer capitalizes to goods in its inventory those costs determined by the Regulations to constitute a part of the total "cost" of those goods. The sum of all costs capitalized to a good constitutes the "cost" of that good.

Section 1.471-3 of the Regulations defines how the "cost" of a taxpayer's inventories is determined; specifically, by defining what costs make up the "cost" of the goods of which the taxpayer takes an inventory. In the case of goods on hand at the beginning of the year that was produced or purchased in a previous taxable year, section 1.471-3(a) states that cost is defined as "the inventory price of such goods." The cost of goods that a taxpayer produces or acquires during the taxable year (as well as the "inventory price" of the goods on hand at the beginning of the taxable year) is determined by different rules, depending on whether the goods were produced by the taxpayer or purchased by the taxpayer for resale.

Under section 1.471-3(b), for goods purchased for resale:

Cost means . . . the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods. But see section 1.263A-1(d)(2)(iv)(C) for special rules for certain direct material costs that in certain cases are permitted to be capitalized as additional section 263A costs by taxpayers using a simplified method under section 1.263A-2(b) or (c) or section 1.263A-3(d). For taxpayers acquiring merchandise for resale that are subject to the provisions of section 263A, see sections 1.263A-1 and 1.263A-3 for additional amounts that must be included in inventory costs.

Broadly summarized, section 1.471-3(b) defines the cost of goods purchased for resale to be the sum of the purchase price of the goods (less certain discounts) and costs incurred to acquire possession of the goods (i.e. transportation or other necessary charges incurred in acquiring possession of the goods.)

### ANALYSIS

Because Taxpayer purchases and resells goods that constitute merchandise, Taxpayer is required to take inventories of its goods pursuant to section 471(a) of the Code and

section 1.471-1(a) of the Regulations.<sup>1</sup> In taking an inventory under section 471, the regulations under 1.471-2 require Taxpayer to “value” the goods for which it is taking an inventory. The section 1.471-2 regulations set forth certain permissible methods of valuation, including valuing inventories “at cost.” Section 1.471-3 defines what it “means” for inventories to be valued at cost.

The term “means” as used in section 1.471-3 indicates that the language that follows such term in section 1.471-3 is intended to be an exclusive, rather than illustrative, list of costs that constitute the “cost” of goods when a taxpayer values such goods at cost under section 1.471-2. The Supreme Court has explained that “[a]s a rule, a definition which declares what a term ‘means’ . . . excludes any meaning that is not stated.” Burgess v. United States, 553 U.S. 124, 130 (2008) (quoting Colautti v. Franklin, 439 U.S. 379, 392–393, n.10 (1979)). The best reading of the regulation, therefore, is that the term “cost” as used in section 1.471-3(b) for a taxpayer that purchases and resells goods means “the invoice price less trade or other discounts” plus “transportation or other necessary charges incurred in acquiring possession of the goods.” Thus, section 1.471-3(b) does not permit the capitalization of additional amounts beyond the amount that constitutes the cost of such inventories under such section; instead, the regulations specify exactly how the cost of certain goods in inventory must be determined.<sup>2</sup>

As such, because Taxpayer values its goods at cost, Taxpayer must determine the cost of its goods pursuant to the applicable rules in section 1.471-3(b) of the Regulations. Therefore, under Taxpayer’s facts, the amounts that Taxpayer capitalizes to determine the cost of its goods are the invoice price of the goods that it purchases, plus the transportation costs and the other necessary charges Taxpayer incurred in having the goods shipped from the producer (Taxpayer’s “acquisition costs”). These are the amounts that Taxpayer incurred that are described in section 1.471-3(b) as constituting the “cost” of Taxpayer’s goods.

All other amounts incurred by Taxpayer, including the purchasing costs, the storage and handling costs, the costs of preparing the goods for resale, including any inspection costs, packaging costs, and the labor associated with these activities, and selling expenses, including the associated labor, are not considered to be part of the “cost” of the merchandise under section 1.471-3(b). As such, these amounts are not permissibly capitalizable pursuant to the rules for determining cost under section 1.471-3(b) as they are not part of the “cost” of the goods as defined under section 1.471-3(b), but may instead be deducted as period costs assuming that such costs have been incurred under section 461 of the Code and are permissibly deductible under a section of the Code and/or the Regulations.

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<sup>1</sup> This statement would be inapplicable if a taxpayer permissibly chooses to account for its inventory using a method described in section 471(c) of the Code (and the applicable Regulations).

<sup>2</sup> This analysis is not applicable to the capitalization of costs by taxpayers under sections 1.471-3(c) and 1.471-11 to property produced, and under authorities such as Adolph Coors Co. v. Commissioner, 519 F.2d 1280 (10th Cir., 1975) cert. denied 423 U.S. 1087. The treatment of such taxpayers is beyond the scope of this memorandum.

Taxpayer does not apply the rules in section 263A of the Code (or the associated Regulations) in determining the costs that it capitalizes to the goods in its inventory or the manner in which it allocates costs to the goods. Therefore, the sentences in section 1.471-3(b) coordinating such section with the rules under section 263A and its corresponding regulations do not apply to Taxpayer. Further, this Chief Counsel Advice neither expresses nor implies any opinion concerning what additional costs would be permitted or required to be capitalized to the goods had Taxpayer applied the rules under section 263A and its regulations.<sup>3</sup>

Also, because Taxpayer is not using a method of accounting described in section 471(c) of the Code, this Chief Counsel Advice neither expresses nor implies any opinion about what costs would be permitted or required to be capitalized to the goods had Taxpayer applied the rules under section 471(c).

Finally, if Taxpayer desires to change its method of accounting, Taxpayer must obtain permission from the Commissioner using either the automatic or advance consent accounting method change procedures described in Rev. Proc. 2015-13 to change its method of accounting.<sup>4</sup>

Please call Evan K. Hewitt at (202) 317-7007 if you have any further questions.

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<sup>3</sup> It should be noted that for taxpayers applying the rules under section 263A, “section 471 costs” and “additional section 263A costs” are terms of art under section 263A with specific rules for identifying which costs fall in one of those two categories; consequently, the specific costs a taxpayer capitalizes under section 471 as described in this Chief Counsel Advice do not necessarily correspond to the specific costs treated as “section 471 costs” for taxpayers applying section 263A.

<sup>4</sup> For example, if Taxpayer desires to change to a method of accounting that applies the rules under section 263A and the corresponding regulations and/or incorporates a method of accounting described in section 471(c).